

One of the most challenging aspects of orchestrating a Reverse or Improvement Exchange is securing financing for the Replacement Property. Typically, Exchangers find the most success in obtaining a loan for this type of exchange by relying on their existing banking relationships. Some lenders may not be willing to comply with the non-recourse language required by IPX1031 when it acts as the titleholder. Early in the planning process IPX1031 may be able to provide an Exchanger with a list of local lenders who are willing to participate in Reverse or Improvement Exchanges.

Title to the property is held in a Special Purpose Entity (SPE), whose sole member is affiliated with IPX1031. The SPE should be the borrower under any acquisition or construction loans. It is a good idea to advise the lender of the involvement of the SPE and the structure of the transaction early in the process. In the initial discussions, the lender should also be supplied with the IPX1031 standard non-recourse language.

Non-Recourse Requirement:

When a loan is “non-recourse” the lender agrees not to proceed personally against the borrower (i.e. the IPX1031 entity that is the sole member of the SPE) for liability under the loan. In other words, the lender agrees that its only remedies in the event of a default are to proceed against the property that secures the loan, as well as any guarantor.

Before the SPE will sign any loan documents, the loan must be entirely non-recourse as to our entities. (See Brief Exchange on Third Party Notes and Security Instruments for sample nonrecourse language.) This is a requirement for all loans the SPE signs, whether they are acquisition loans, assumption papers, or construction financing. Most lenders will require that the Exchanger personally guarantee the loan.

IPX1031 will review the loan documents for any affirmative actions or indemnity requirements the lender may place on the borrower. Often lenders will have a non-recourse provision in the loan agreement and then insert separate indemnifications from the borrower in other sections of the loan documents. Such responsibilities must be removed or transferred to the Lender’s guarantee agreement with the Exchanger.

“Carve-Outs” to Non-recourse Provisions:

Many non-recourse loans will exempt or “carve-out” certain items or actions from the non-recourse limitation. The three most common carve-outs are for waste, environmental contamination, and borrower fraud. The loan must be entirely non-recourse as to the SPE and its sole member, with no carve-outs. IPX1031 will instruct the lender that the Exchanger, as guarantor under the loan, will need to have the liability for the “carve-outs”, not the SPE.

Exchanger as Borrower or Co-Borrower:

On occasion lenders may be unwilling to list the SPE as the borrower. The lender may suggest that the Exchanger be the borrower under the Note and the SPE simply be the grantee on the deed of trust or mortgage. Another course of action is to have the Exchanger borrow the funds from the lender by signing a promissory note. The Exchanger then loans those funds to the SPE. The SPE gives the Exchanger a mortgage or deed of trust on the parked property. The Exchanger then assigns that deed of trust or mortgage to the lender as collateral for its original loan.

A more simple structure is to have the SPE and Exchanger as co-borrowers on the loan. Revenue Procedure 2000-37 permits Exchangers to enter into a variety of permissible agreements with regard to the financing of the parked property acquisition for a safe harbor Reverse Exchange. A co-borrower structure should qualify as a permissible agreement. (The same is not true for exchanges structured outside the safe harbor of Rev. Proc. 2000-37.)

Third-Party Loans with Accommodator on Title (CONT.)

Special Issues Regarding Financing in Relinquished Property Parked Reverse Exchanges:

When the SPE is holding the Relinquished Property, the Exchanger will most often have the SPE take title “subject to” the existing debt. That type of conveyance would likely constitute a transfer that could trigger a “due on sale” clause under the existing loan. The Exchanger should discuss the potential effect of triggering the due on sale clause with its tax advisors. Another option is to have the SPE assume the existing debt. Any assumption would require the lender’s consent. The documents must provide that the SPE is assuming the loan on a non-recourse basis.

If the Exchanger does not have sufficient cash for the down payment on the Replacement Property it may consider refinancing the Relinquished Property to obtain the necessary funds. A better course of action is for the Exchanger to discuss having the existing lender provide new financing for the SPE purchase of the Relinquished Property. The new financing would enable the Exchanger (through its Qualified Intermediary) to receive cash to put down on the Replacement Property while protecting against the concerns involved in refinancing prior to an exchange. There is a risk that the IRS may re-characterizing the equity pulled out of the Relinquished Property as cash boot, and taxable.

Special Issues Regarding Cross Collateralized Financing in Replacement Property Parked Reverse Exchanges:

Sometimes the lender for the Replacement Property will require that the Relinquished Property also serve as collateral for its loan on the Replacement Property (“cross collateralization”). When the Relinquished Property sells the lender will need to release its lien so the buyer gets clear title. The lender may condition its release upon having the sales proceeds paid to the lender from escrow. Such a direct payment to the lender may trigger a “(g)(6) event”, i.e. an impermissible pledge of exchange funds by the Exchanger, which could disqualify the exchange. There are three alternatives that may avoid a (g)(6) event: (i) the Exchanger can pledge its rights under the Exchange Agreement to the lender, which includes the right to receive the proceeds upon a (g)(6) event; (ii) the Exchanger can enter into an “Irrevocable Direction to Disburse”, which requires the QI to pay any unused exchange funds to the lender; or (iii) the QI can receive the proceeds from escrow, then disburse them to the EAT as an irrevocable down payment on the Replacement Property. The EAT can then pay the funds to the lender to reduce the loan balance.

Special Issues Regarding Construction Loans:

Occasionally in an Improvement Exchange there is a need to obtain a construction loan after the SPE has already taken title. This situation should be handled the same as an acquisition loan (discussed above). In most instances the SPE will be the borrower on a non-recourse basis, with the Exchanger guaranteeing the loan.

Special Purpose Entities:

IPX1031 will form a SPE to hold title in all Reverse and Improvement Exchanges. The SPE is typically a single member limited liability company that holds the assets of one exchange transaction. The sole member of the SPE is an entity that is wholly owned by IPX1031. For safe harbor exchanges, the entity is “National Safe Harbor Exchanges, Inc.” (See Brief Exchange on Special Purpose Entities for additional information.)

On occasion a third-party lender will require an opinion letter from the SPE’s outside legal counsel as to its formation and authorization. Opinion letters can be costly and also cause timing delays. If IPX1031 is required to engage counsel to issue an opinion letter, all costs will be passed on to the Exchanger. A minimum of ten (10) business days advance notice is necessary if an opinion letter will be required.